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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

Nos. 739-740

INTERNATIONAL STANDARD ELECTRIC CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

ALLIN H. PIERCE,
Counsel for the Petitioner.

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International Standard Electric Corporation,
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Commissioner of Internal Revenue,
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Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

International Standard Electric Corporation, the petitioner above named, prays that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Second Circuit entered in the above-entitled cases on September 9, 1944 (R. 102, 104), affirming in part the decisions of The Tax Court of the United States (R. 55).

Opinions Below.

The opinion of the Tax Court (R. 42-54), which covers both of the cases involved, is reported in 1 T. C. 1153.

The opinion of the Circuit Court of Appeals for the Second Circuit (R. 95-101), which likewise covers both cases, is reported in 144 F. 2d 487.

Jurisdiction.

The judgments of the Circuit Court of Appeals were entered on September 9, 1944 (R. 102, 104). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

The issue relates to the credits allowable against United States income taxes, under Section 131 of the Revenue Acts of 1936 and 1938, for taxes paid or accrued to foreign countries.

The sole question presented is whether the applicable statutes compel the invalidation, retroactively, of provisions of treasury regulations and official forms which, for more than twelve years, have specified the method for calculating foreign tax credits and have required taxpayers to employ such method as a condition to allowance of the credits.

Petitioner contends that the regulations and official forms, upon which both the Government and it relied during the taxable years, should be sustained. The Court below rejected this contention, with the following statement (R. 100):

> "It is because of the clear terms of the statute that it is impossible for us to sustain contentions of the taxpayer based upon administrative procedure in prior years and some indications in Treasury Form 1118 which seem to bear a contrary interpretation of the meaning of the statute."

Statutes, Regulations and Treasury Form Involved.

The statutes, regulations and treasury form involved are set forth in the Appendix, *infra*.

Statement of Matter Involved.

These cases involve deficiencies in income taxes and excess-profits taxes determined against the petitioner for the calendar years 1937 and 1938, respectively. Both involve the same issue which, as stated above, pertains to the credit for foreign taxes allowable under Section 131 of the Revenue Acts of 1936 and 1938. The cases were consolidated below (R. 89), although separate judgments were entered; and they come before this Court on a consolidated record.

The cases appear to be test cases in which the respondent is attempting to establish, through judicial decision rather than by legislative action, a new method for computing foreign tax credits, which is contrary to the method of computation which the Treasury, for more than twelve years, has uniformly prescribed in its regulations and official forms, including those now in force.[1]

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[1] Article 131-3 of the Regulations (*infra*, p. 19) provides that every corporation must, as "Conditions of Allowance of Credit," attach Form 1118 to its income tax return and, under oath, supply "the information there called for" and make "the calculations of credits there indicated."

Form 1118 (*infra*, p. 22) shows that, for each foreign country in respect of which credit is claimed, "Income * * * exclusive of dividends received" and "Dividends received" are to be treated separately; and that the full amount of "Dividends received" is to be included in the "Total income" which is used in computing the foreign tax credit.

Article 131-8 of the Regulations (*infra*, p. 19) employs examples to illustrate "the operation of the limitations on the credit for foreign taxes"; and Example (3) thereof shows that,

[Footnote continued on following page.]

Under this prescribed method of computation, dividends from foreign corporations are separated from the other classes of foreign income; and, unlike such other classes, the full amount of "Dividends received" is included in the total *net* income from foreign sources, without deduction of any expenses. Such treatment apparently is based upon the principle that foreign dividends are earned and distributed at the expense of the foreign corporation alone, and that no expenses of the domestic stockholder are attributable to them.

Under the method of computation for which the respondent now contends, the distinction between "Income * * * exclusive of dividends received" (business income) and "Dividends received" (investment income) is wiped out; both classes of income are commingled, apparently in direct violation of the requirements of the above-mentioned regulations and official forms of the Treasury; and consequently, dividends received from foreign corporations are charged with an allocated portion of the taxpayer's expenses. The effect is that there is not a true reflection of net income by countries, for, where

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[Footnote continued from preceding page.]

where a domestic corporation received income from France which was derived partly from "dividends" and partly from "branch operations," the dividends should be treated separately, and the full amount thereof should be included as an item of the "Total foreign net income" used to compute the credit.

The above-described provisions of the Regulations were included in Articles 693 and 698 of Regulations 77 (1932); and they were thereafter repromulgated without material change in Articles 131-3 and 131-8 of Regulations 86 (1934), 94 (1936), 101 (1938), 103 (1940) and 111 (1943).

Form 1118 has been reissued annually since 1932 without material change, except that since 1942 the more exact terms "Net income * * * exclusive of dividends received" and "Total net income" have been employed. This further emphasizes the fact that the full amount of "Dividends received" is to be regarded as a "net" figure.

investment income is derived from one foreign country and business income is derived from another, the net income from the first country is reduced by expenses which have no relation to the production of the dividends, while the net income from the other country is overstated through failure to deduct all expenses attributable to the production of the business income. Such method also affects the amount of the taxpayer's allowable credit by attributing to certain countries less credit than can be used, and by attributing to other countries increased credit which cannot be used because in excess of the foreign tax paid. In the instant case, application of this revised method of computation caused a major part of petitioner's expenses to be apportioned against dividends distributed to it by foreign corporations[2] and resulted in the assertion of a substantial deficiency in tax for each of the years involved (R. 11-13, 31-33).

The respondent's revised method of computation did not result from any change in the controlling statutes or regulations, for these have not been materially changed since 1932. As regards petitioner, the new method was first invoked in 1941 on the audit of petitioner's 1937 and 1938 income taxes, after its 1935 and 1936 taxes had

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[2] Petitioner's business income for the years involved consisted principally of profits from export sales, royalties from patents, fees under contracts to provide management services, and interest (R. 44-45).

Its investment income for said years consisted of dividends accrued from 18 corporations in 1937 and from 17 corporations in 1938 (Physical Exhibits 1 and 2, Sched. 2). The corporate stocks upon which these dividends were distributed had been owned by petitioner for many years and were not traded in but were held passively (R. 47, 75, 77, 82); and an officer of petitioner testified that the dividends therefrom flowed to petitioner without any expense on its part (R. 81-82, 85-86).

Computations made by the petitioner indicate that the amounts of petitioner's expenses apportioned to foreign dividends, under respondent's revised method of computation, were $747,272.25 for the year 1937 and $1,181,187.63 for the year 1938.

been finally adjusted through application of the prior method and also after its 1937 tax had been adjusted through application of that method in two previous audits which petitioner had accepted (Physical Exhibits 3; 4; 5, p. 1; 6, pp. 2-3). Only one other decided case has been found in which this new method of computation has been applied; and that involved taxable years subsequent to those here involved and was decided by the Tax Court on authority of the instant case (*South Porto Rico Sugar Co.*, 2 T. C. 738 (1943)).

The respondent's position appears to be that the method for computing foreign tax credits prescribed in the above-mentioned regulations and official forms, should not be given effect.[3] He contends that determination of the amount of income derived from each foreign country is controlled by Clause (1) of Section 131(e) of the statutes which make reference to Section 119; and that the determination of such amount is not controlled by Clause (2) of Section 131(e), which states expressly: "Such amount to be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary,". The respondent further contends that, upon application of Section 119(d), the major part of the expenses of petitioner must be allocated against the dividends received from foreign corporations, which were earned, distributed, and taxed at source abroad before they were includible in petitioner's income.

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[3] The respondent in his brief for the Circuit Court of Appeals said (pp. 14-15):

"The example [Example (3) in Art. 131-8, Regs. 94 and 101] lends some support to the taxpayer's contention * * *."

"Treasury Form 1118 tends to support the taxpayer's position in that it separately calls for net income exclusive of dividends received, and the amount of dividends received. * * * Matter contained in a form cannot constitute a binding administrative construction. * * * And in no case may the form and the example in Art. 131-8 be given effect contrary to the plain meaning of the statute."

The petitioner's position, on the other hand, is that respondent's newly adopted construction of Section 131(e) and also his construction of Section 119(d), both of which he must sustain to support the deficiencies here involved, are erroneous; and that neither of these sections requires disregard or invalidation of the long-established administrative practice. Petitioner contends, first, that respondent's construction of Section 131(e) would make the second clause of that section redundant and ineffective; but that both clauses of the section can be given effect and the long established administrative practice can be sustained, if Clause (1) is construed to employ Section 119 for the purpose of classifying income as to "sources" (from within or from without the United States), and if Clause (2) is construed to give the Treasury power to prescribe, through its rules and regulations, the methods and details of computing "the amount of income derived from each country".

Secondly, the petitioner contends that, even if Section 119 does control the determination of the amounts of income by countries, the method of computation prescribed in the regulations and in Treasury Form 1118 still should be sustained. Section 119(d) (*infra*, p. 17) requires, in substance, that the expenses of the taxpayer must, if possible, be allocated directly to the particular items and particular classes of income to which they pertain; that if such direct allocations cannot be made, the expenses must be ratably apportioned among those particular classes of income to which they are attributable; and that only as a last resort may an arbitrary apportionment be made ratably against income of all classes.

The Tax Court sustained the respondent's contentions (R. 49-52) without making any reference whatever to the established administrative practice or to the above-men-

tioned regulations and official forms of the Treasury Department; also, in connection with its holding on this point, it cited no judicial authority except a comparative reference to *Third Scottish American Trust Co., Ltd. v. United States*, 37 F. Supp. 279 (Ct. of Cls.—1941), which did not involve either a domestic corporation or the calculation of foreign tax credits.

The Circuit Court of Appeals affirmed the Tax Court's decision, but indicated reluctance to overrule the established administrative practice. The Court cited no judicial authority and did not refer to the regulations. It did modify the Tax Court's decision by holding that royalty expenses which could not be allocated directly must be apportioned ratably against income produced by the royalty expense; but it failed to apply this principle to the greater part of petitioner's expenses, and to apportion them ratably against all business income as a class, rather than against both business income and investment income.

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1. In failing to give effect to the requirements of regulations and official forms of the Treasury Department, which have been in effect for many years and upon which both the Government and the petitioner relied during the taxable years involved.

2. In holding that Section 131(e) of the applicable statutes requires the amount of income derived from each foreign country to be determined under Section 119 of

the statutes, rather than under "rules and regulations prescribed by the Commissioner with the approval of the Secretary".

3. In failing to hold that, even if Section 119 controls the determination of income by countries, business expenses must, in accordance with the requirements of the regulations and official forms of the Treasury, be allocated or apportioned only to items and classes of business income, and not to investment income to which they are not attributable.

Reasons for Granting the Writs.

I.

The Circuit Court of Appeals has decided an important question of Federal law which has not been, but should be, settled by this Court.

The decisions below defeat, in a large measure, the intention of Congress to prevent international double taxation. All revenue acts in force since the enactment of the Revenue Act of 1918 have permitted taxpayers to claim credit against their United States income taxes for income, war profits, and excess-profits taxes paid to foreign countries. (Rev. Acts 1918, 1921, 1924, and 1926, Secs. 222, 238; Rev. Acts 1928, 1932, 1934, 1936, 1938 and I. R. C., Sec. 131.) The purpose of Congress in providing such credits was to encourage foreign commerce and facilitate foreign enterprise by mitigating the evil of double taxation that arises when each of two sovereignties imposes tax upon the same income, one sovereignty having jurisdiction over the person of the taxpayer and

the other having jurisdiction over the income at its source. *Burnet* v. *Chicago Portrait Co.*, 285 U. S. 1, 9 (1932); Ways and Means Committee Report on the 1918 Revenue Bill, 65th Cong., 2d Sess., H. Rept. 767, p. 11.

Under the 1918 Act, the amount of credit allowable was the full amount of foreign tax paid; but under subsequent Acts a limitation has been imposed upon the amount of credit allowable, in order to prevent the United States tax being excessively reduced in situations where high foreign tax rates might create a larger credit than is necessary to prevent double taxation. (See Section 131(b), *infra*, p. 18). The scheme of these limitation provisions is, in effect, to determine what part of the United States tax has been imposed on the income received from a particular foreign country, by observing the ratio of the net income from that country to the total net income from all sources; and then to limit the credit to an amount equal to the United States tax on such country's income. The result is that, if the income tax collected by foreign countries on such income has been imposed at rates which were equal to or less than the United States tax rates, the full amount of the foreign tax will be allowable as a credit; but if the foreign rates were higher than the United States tax rates, only that portion of the foreign tax will be allowed as a credit which is sufficient to offset the corresponding tax imposed in the United States. (See discussion in the House on the 1932 Revenue Bill, Cong. Rec. Vol. 75, pp. 6490, 6492-93.)

Under the revised method of computation which the respondent is attempting to use in the instant case, the credit would be limited, not merely to the extent necessary to prevent double taxation, but rather to a point where double taxation would exist despite the credit. There would not be included in net income from certain

foreign countries, the full amount of the foreign dividends upon which the foreign tax was imposed, but a reduced amount of dividend income remaining after deduction of an apportioned part of the taxpayer's expenses. It follows that the ratio of net income from such countries to total net income would be understated; and that full credit would not be given for the foreign tax paid on the dividends, even though the foreign tax rates were no higher than the United States tax rates. The effect would be double taxation.

The decisions below will affect practically every American concern doing business abroad. They run counter to the policy of Congress, as evidenced by the foreign tax credit provisions of the statute, to encourage business with foreign countries—a policy which can be expected to attain increased importance in the post war period. Moreover, if the expenses of a corporate taxpayer may be apportioned to dividends distributed to it by foreign corporations, it would appear that the door has been opened for a similar apportionment of expenses of individual taxpayers.

II.

The Circuit Court of Appeals has decided a Federal question in a way probably in conflict with applicable decisions of this Court.

The Treasury Regulations (Art. 131-3, *infra*, p. 19) have, as before stated, required for many years that every taxpayer claiming foreign tax credit shall attach to its income tax return a copy of the official form prescribed for that purpose (in the case of a corporation, Form 1118), and that it shall, under oath, supply "the

information there called for" and make "the calculations of credits there indicated". Because of these requirements and the fact that the calculations are necessarily complicated, taxpayers have regarded the treasury regulations and forms as guides upon which they might safely rely in computing their tax liabilities.

The respondent is now attempting to revise, retroactively, the method of calculation prescribed in these regulations and forms. He is attributing to the statute a meaning which, if it exists at all, is so obscure that the Treasury itself did not discover it until many years after the statute had been enacted and the rules for its application had been established.

This Court has recognized that such retroactive revisions should not be permitted. In *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), wherein an attempt was made to tax stock dividends retroactively, the Court said (pp. 402-3):

> "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability. * * * if he asked the tax collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. * * * To rip out of the past seven years of tax administration a principle of law on which both Government and taxpayers have acted would produce readjustments and litigation so extensive we would contemplate them with anxiety. We have recently held as to another questioned decision of this Court that a long period of accommodations to an older decision sometimes requires us to adhere to an unsatis-

factory rule to avoid unfortunate practical results from a change. *Davis* v. *Department of Labor*, 317 U. S. 249. We think this another example of the same principle."

This Court also has held in several cases that the requirements of treasury regulations, long continued without substantial change, may not be revised retroactively after Congress has reenacted the statutes which they interpreted. In *Helvering* v. *Reynolds Co.*, 306 U. S. 110 (1939), it said (p. 116):

> "Since the legislative approval of existing regulations by reenactment of the statutory provision to which they appertain gives such regulations the force of law, we think that Congress did not intend to authorize the Treasury to repeal the rule of law that existed during the period for which the tax is imposed."

Similarly, in *Helvering* v. *Winmill*, 305 U. S. 79 (1938), the Court said (p. 83):

> "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."

Conclusion.

It is respectfully submitted that the within petition should be granted.

International Standard Electric Corporation,
Petitioner,

By Allin H. Pierce,
Counsel for the Petitioner.

Dated: 111 West Monroe Street,
Chicago 3, Ill.,
December 9, 1944.